

## Internal Revenue Service

Number: **200905014**

Release Date: 1/30/2009

Index Number: 1362.00-00, 1362.04-00

## Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B02

PLR-119984-08

Date:

October 24, 2008

### Legend

X =

Trust =

Beneficiary =

A =

B =

Property1 =

Property2 =

Property3 =

c =

d =

e =

f =

n =

State =

Date1 =

Date2 =

Date3 =

Date4 =

Date5 =

Year1 =

Year2 =

Dear \_\_\_\_\_ :

This responds to a letter dated April 25, 2008, submitted on behalf of X by X's authorized representative, requesting rulings under § 1362(f) and 1362(d)(3)(C)(i) of the Internal Revenue Code (the Code).

The information submitted states that X was incorporated under the laws of State on Date1. X elected to be an S corporation effective Date2. X is engaged in managing, leasing, marketing, and acquiring commercial and residential real estate properties.

According to the information submitted and representations made by X, A established Trust on Date3 and appointed B as trustee. Under the terms of the trust agreement, A was the income beneficiary of Trust for the duration of A's life. Upon A's death, Beneficiary would be the income beneficiary of Trust for the duration of Beneficiary's life. A died before the date of X's S corporation election on Date2. X represents that X and all of its shareholders believed, at the time its S corporation election was made, that Trust met the requirements of a Qualified Subchapter S Trust (QSST) and that Trust had made a valid election to be a QSST. However, X recently discovered that: (1) X's S corporation election on Date2 was ineffective because B, and not Beneficiary, consented to X's S corporation election; (2) Trust failed to qualify as a QSST because B, and not Beneficiary, made the QSST election under § 1361(d)(2); and (3) Trust failed to distribute all of the trust accounting income to Beneficiary annually from Date2 to Date4 as required under § 1361(d)(3)(B). X represents that

Trust otherwise meets the requirements of § 1361(d)(3)(A) and that Beneficiary consents to the S corporation election and QSST election as of Date2.

X represents that X and X's shareholders have filed tax returns consistent with X being an S corporation from Date2. X also represents that the circumstances resulting in the termination of X's S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning. X and each person who was or is a shareholder of X at any time since Date2 agree to make any adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary with respect to such period. X further represents that Trust meets the requirements to be treated as an Electing Small Business Trust (ESBT) within the meaning of § 1361(e)(1) as of Date5.

According to the information submitted and representations made by X, X owns Property1, Property2, and Property3 (collectively "the Properties"). Property1 is a residential real estate property that is leased to tenants. Property2 and Property3 are commercial real estate properties that are also leased to tenants. X, through its employees or independent contractors, provides certain services with respect to the leasing of the Properties. These services involve maintaining and repairing the buildings and grounds, including cleaning, electrical, plumbing, roof and structural maintenance, HVAC, landscaping, security, and pest abatement.

In Year1, X collected approximately \$c in gross rents and incurred approximately \$d in relevant operating expenses for the Properties. In Year2, X collected approximately \$e in gross rents and incurred approximately \$f in relevant operating expenses for the Properties. X also represents that X has accumulated earnings and profits.

#### RULINGS REQUESTED

1. To the extent that the S corporation election of X on Date2 was ineffective due to the failure of Beneficiary to consent to the S corporation election, or was terminated due to either the failure of Beneficiary to make the QSST election on behalf of Trust or the failure of Trust to distribute all of the trust accounting income to Beneficiary on an annual basis, such ineffectiveness or termination was inadvertent for purposes of § 1362(f). For this purpose, Trust will be treated as a valid QSST from Date2 to Date4. In addition, Trust will be permitted to convert to an ESBT effective on Date5.
2. The rental income received by X from the Properties is not passive investment income within the meaning of § 1362(d)(3)(C)(i).

#### RULING 1

Section 1362(f) provides that if (1) an election under § 1362(a) by a corporation (A) was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consents or (B) was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation or (B) to acquire the shareholder consents, and (4) the corporation and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation will be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election was ineffective on Date2 resulting from the failure of Beneficiary, as the income beneficiary of Trust, to consent to the S corporation election under § 1362(a)(2). In addition, even if X's S corporation election had been effective, the election would have terminated from the failure of Beneficiary to make the QSST election on behalf of Trust under § 1361(d)(2). X's S corporation election would also have terminated due to the fact that Trust would have ceased being a QSST by failing to distribute all of the trust accounting income to Beneficiary on an annual basis during the period from Date2 to Date4, as required under § 1361(d)(3)(B). We conclude that the ineffective S corporation election was inadvertent within the meaning of § 1362(f). We also conclude that, to the extent that X's S corporation election would have terminated as a result of either of the terminating events described above, such termination would have been inadvertent within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as being an S corporation beginning on Date2, and continuing thereafter, provided that X's S corporation election was valid and the election was not otherwise terminated under § 1362(d) for reasons not addressed in this letter.

In addition, based solely on the facts and representations made, we conclude that Trust may convert to an ESBT, effective as of Date5. Both the trustee of Trust and Beneficiary must sign and file the ESBT election effective Date5 with the appropriate service center within 60 days from the date of this letter. A copy of this letter should be attached to the ESBT election.

The following conditions must be met: (1) Trust must, within a reasonable time, distribute \$n to Beneficiary, representing the amount that should have been distributed to Beneficiary for the period from Date2 to Date4, as required under § 1361(d)(3)(B) to be treated as a valid QSST; (2) the shareholders of X must include in their income their

pro rata share of separately stated and nonseparately stated items of X as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368; (3) X and each of its shareholders must file any amended returns and make such adjustments that are necessary to properly reflect the reporting of X's items of S corporation income; and (4) Trust and Trust's beneficiary must file any amended returns and make adjustments that are necessary to properly reflect the treatment of Trust as an ESBT beginning Date<sup>5</sup>. If X or its shareholders fail to meet any of these conditions or treat X as described above, this ruling shall be null and void.

## RULING 2

Except as provided in § 1362(g), § 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) shall be terminated whenever the corporation (1) has accumulated earnings and profits at the close of each of three consecutive taxable years, and (2) has gross receipts for each of such taxable years more than 25 percent of which are passive investment income.

Except as otherwise provided in § 1362(d)(3)(C), § 1362(d)(3)(C)(i) provides that the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1.1362-2(c)(5)(iii)(B)(i) of the Income Tax Regulations provides that "rents" means amounts received for the use of, or the right to use, property (whether real or personal) of the corporation.

Section 1.1362-2(c)(5)(ii)(B)(2) provides that "rents" does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in the active trade or business of renting property only if, based on all of the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all of the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Based solely on the facts submitted and the representations made, we conclude that the rental income X receives from the rental of the Properties is not passive investment income under § 1362(d)(3)(C)(i).

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code, including whether X was or is a small business corporation under § 1361(b) or Trust's eligibility to be an ESBT under § 1361(e). Further, the passive investment income rules of § 1362 are independent of the passive activity loss rules of § 469; unless an exception under § 469 applies, the rental activity remains passive for purposes of § 469.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, copies of this letter are being sent to X's authorized representatives.

Sincerely,

Melissa C. Liquerman  
Senior Technician Reviewer, Branch 2  
Office of Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2)  
Copy of this letter  
Copy for § 6110 purposes

cc: